

Letter of Findings: 10-0121
Sales and Use Tax
For the Years 2006, 2007, and 2008

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ISSUES

I. Sales and Use Tax – Imposition.

Authority: IC § 6-2.5-1-1 et seq.; IC § 6-2.5-1-27; IC § 6-2.5-2-1; IC § 6-2.5-4-1; IC § 6-8.1-5-1; [45 IAC 2.2-4-1](#); [45 IAC 2.2-4-2](#); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Sales Tax Information Bulletin 2 (December 2006); Microsoft Press Computer Dictionary (2d ed. 1994).

Taxpayer protests the imposition of sales tax on its sales of software maintenance agreements.

II. Tax Administration – Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; [45 IAC 15-11-2](#).

Taxpayer protests the imposition of the ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is an Indiana company selling both computer hardware and prewritten computer software programs that are used primarily in medical facilities and credit unions. Those customers also purchase hardware and software maintenance agreements from Taxpayer annually. Pursuant to an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer purchased tangible personal property without paying sales tax at the time of its purchases or self-assessing and remitting the use tax due to the Department. The Department also determined that Taxpayer not only failed to collect sales tax on delivery charges, but also failed to collect sales tax on its sales of the software maintenance agreements (in which tangible personal property were transferred to its customers pursuant to the maintenance agreements). As a result, the Department's audit assessed Taxpayer additional sales tax, use tax, interest, and negligence penalty.

Taxpayer timely protested the imposition of sales tax on its sales of the software maintenance agreements concerning two prewritten software programs ("M" and "N"), as well as negligence penalty. A hearing was held. This Letter of Findings ensues. Additional facts will be provided as necessary.

I. Sales and Use Tax – Imposition.

DISCUSSION

Pursuant to the audit, the Department assessed Taxpayer sales tax on its sales of the software maintenance agreements because Taxpayer did not collect sales tax at the time of the retail transactions. Taxpayer, to the contrary, first asserted that its sales of software maintenance agreements were nontaxable services and, therefore, were not subject to sales tax. In the alternative, Taxpayer claimed that it can demonstrate that only several customers received updates of the prewritten software. Taxpayer thus argued that it should not be responsible for collecting the sales tax if there was no update provided to its customers pursuant to the software maintenance agreements. Taxpayer also claimed that the Department's assessment on the sales of the software maintenance agreements was unconstitutional.

As a threshold issue, all tax assessments are prima facie evidence that the Department's assessment of tax is presumed correct; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Indiana imposes a sales tax on retail transactions and a complementary use tax on tangible personal property that is stored, used, or consumed in the state. IC § 6-2.5-1-1 et seq. "Tangible personal property," as defined in IC § 6-2.5-1-27, "means personal property that: (1) can be seen, weighed, measured, felt, or touched; or (2) is in any other manner perceptible to the senses," including "electricity, water, gas, steam, and **prewritten computer software.**" (**Emphasis added**).

According to Microsoft Press Computer Dictionary, "update" is defined:

As a noun, a new release of an existing software product. A software update usually adds relatively minor new features to a product or corrects errors (bugs) found after the program was released. Updates are generally indicated by small changes in software version numbers, as in incrementing version 4.01 to 4.02. Microsoft Press Computer Dictionary 404 (2d ed. 1994).

Additionally, "patch" means:

In programming, to repair a deficiency in the functionality of an existing routine or program, generally in response to an unforeseen need or set of operating circumstances. Patching does not necessarily imply sloppiness in implementing a solution to a problem: Patching is a common means of adding a feature or a function to an existing version of a program until the next version of the software, which presumably will have that feature or function included in its design, is released. Microsoft Press Computer Dictionary 293 (2d ed.

1994).

Since a patch is a piece of software commonly used to add a feature or a function to an existing software program and usually is included into the next update, a patch to a prewritten software program is an update of the prewritten computer software. Thus, any update or updates of prewritten computer software, including patches, are tangible personal property pursuant to IC § 6-2.5-1-27.

IC § 6-2.5-2-1 states:

- (a) An excise tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana.
- (b) The person who acquires property in a retail transaction is liable for the tax on the transaction and, except as otherwise provided in this chapter, shall pay the tax to the retail merchant as a separate added amount to the consideration in the transaction. The retail merchant shall collect the tax as agent for the state.

IC § 6-2.5-4-1, in pertinent part, provides:

- (a) A person is a retail merchant making a retail transaction when he engages in selling at retail.
- (b) A person is engaged in selling at retail when, in the ordinary course of his regularly conducted trade or business, he:
 - (1) acquires tangible personal property for the purpose of resale; and
 - (2) transfers that property to another person for consideration.
- (c) For purposes of determining what constitutes selling at retail, it does not matter whether:
 - (1) the property is transferred in the same form as when it was acquired;
 - (2) the property is transferred alone or in conjunction with other property or services; or
 - (3) the property is transferred conditionally or otherwise.

[45 IAC 2.2-4-1](#) further illustrates:

- (a) Where ownership of tangible personal property is transferred for a consideration, it will be considered a transaction of a retail merchant constituting selling at retail unless the seller is not acting as a "retail merchant".
- (b) All elements of consideration are included in gross retail income subject to tax. Elements of consideration include, but are not limited to:
 - (1) The price arrived at between purchaser and seller.
 - (2) Any additional bona fide charges added to or included in such price for preparation, fabrication, alteration, modification, finishing, completion, delivery, or other services performed in respect to or labor charges for work done with respect to such property prior to transfer.
 - (3) No deduction from gross receipts is permitted for services performed or work done on behalf of the seller prior to transfer of such property at retail.

Accordingly, Taxpayer, a retail merchant selling computer hardware and prewritten computer software, is responsible for collecting and remitting to the Department the sales tax due.

The Department's audit noted that, during 2007 and 2008, Taxpayer's software maintenance agreement, in relevant part, states:

Software Maintenance Services For all software to which this Maintenance Addendum applies, [Taxpayer] shall perform, at no additional charge for software, labor or travel: (i) license renewal, (ii) standard updates as determined by [Taxpayer], (iii) error correction, workaround or software re-installation for any material error, malfunction or defect, (iv) unlimited use of Taxpayer's Support Hotline, (v) unlimited attendance at applications training classes at [Taxpayer's] training facilities for no more than two persons per Customer per class, (vi) system consultation services and reviews, (vii) priority service for support and programming needs, and (viii) when necessary and possible, file resizings and/or file rehashing, limited to two per Customer during the Initial Term of this Agreement (any additional file resizings and/or file rehashing shall be at additional charge). (Emphasis added).

Thus, the Department's audit concluded that Taxpayer's software maintenance agreements "specifically highlight the customers' rights to have tangible personal property transferred in the form of updates and license renewals." Taxpayer's documentation showed that Taxpayer's customers must pay for the use of the software annually, and, in return, Taxpayer shall provide a "license renewal," which allows its customer to use the prewritten software programs, as well as "standard updates," which correct errors (bugs) or improve the performances of the prewritten software programs. Thus, Taxpayer's customers have the reasonable expectation that they will be able to continue using the prewritten software programs pursuant to the above agreement. Therefore, the Department's audit correctly determined that Taxpayer's sales of the software maintenance agreements were subject to sales tax as part of a unitary transaction.

"Unitary transaction," as defined in IC § 6-2.5-1-1(a), "includes all items of personal property and services which are furnished under a single order or agreement and for which a total combined charge or price is calculated."

Nonetheless, [45 IAC 2.2-4-2](#) provides an exception and, in relevant part, states:

- (a) Professional services, personal services, and services in respect to property not owned by the person rendering such services are not "transactions of a retail merchant constituting selling at retail", and are not subject to gross retail tax. Where, in conjunction with rendering professional services, personal services, or

other services, the serviceman also transfers tangible personal property for a consideration, this will constitute a transaction of a retail merchant constituting selling at retail unless:

- (1) The serviceman is in an occupation which primarily furnishes and sells services, as distinguished from tangible personal property;
- (2) The tangible personal property purchased is used or consumed as a necessary incident to the service;
- (3) **The price charged for tangible personal property is inconsequential (not to exceed 10 [percent]) compared with the service charge; and**
- (4) **The serviceman pays gross retail tax or use tax upon the tangible personal property at the time of acquisition. (Emphasis added).**

Notably, only when a taxpayer meets all of the above four requirements, can the transaction be considered as providing nontaxable services. In this instance, assuming that Taxpayer has satisfied the first two requirements, Taxpayer still failed to demonstrate that it met the third and the fourth requirements. Taxpayer's sample invoice listed the charge for the maintenance agreements and stated that "Hardware and Software Maintenance fees are invoiced and payable annually." While Taxpayer claimed that it gave its customer the updates for free, its documentation failed to demonstrate that the price charged for the updates and the license renewals is inconsequential compared with the service charge.

Taxpayer also asserted that it received the M software and the updates of the M software free of charge as a result of winning a lawsuit. Taxpayer thus claimed that it was not required to pay sales/use tax at the time of the acquisition. Taxpayer, however, simply provides an affidavit stating that "[d]ue to litigation and a subsequent negotiated settlement, [Taxpayer] receives the [M] software and all of its updates free of charge from its owner...." In the absence of other documentation to substantiate its claim, the Department is not able to agree that Taxpayer has met its burden.

Taxpayer, referring to the Department's Sales Tax Information Bulletin 2 (December 2006), maintained that there is a rebuttable presumption and it can demonstrate that only several customers received the updates. To support its protest, Taxpayer submitted two lists, prepared by one of its employees, stating that the documents showed that certain customers on the two lists received the updates regarding the M and N prewritten software programs during 2007 and 2008. In the absence of other documentation to substantiate its claim, assuming it is applicable in this case, the Department is not able to agree that Taxpayer has met its burden.

Finally, Taxpayer has invited the Department to interpret the U.S. Constitution in its favor. The Department, however, must respectfully decline Taxpayer's invitation to address federal constitutional issues. For one, Taxpayer does not present specific constitutional arguments in support of its protest. Even if Taxpayer had presented such arguments, the administrative hearing is not a proper forum to address Taxpayer's concerns regarding federal constitutional principles.

In short, given the totality of the circumstances, in the absence of other documentation, the Department is not able to agree with Taxpayer that it has met its burden demonstrating the Department's proposed assessment is wrong.

FINDING

Taxpayer's protest on the imposition of sales tax regarding its sales of the software maintenance agreements is respectfully denied.

II. Tax Administration – Negligence Penalty.

DISCUSSION

Taxpayer also protests the imposition of the negligence penalty.

Pursuant to IC § 6-8.1-10-2.1, the Department may assess a ten (10) percent negligence penalty if the taxpayer:

- (1) fails to file a tax return;
- (2) fails to pay the full amount of tax shown on the tax return;
- (3) fails to remit in a timely manner the tax held in trust for Indiana (e.g., a sales tax); or
- (4) fails to pay a tax deficiency determined by the Department to be owed by a taxpayer.

[45 IAC 15-11-2](#)(b) further states:

"Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The Department may waive a negligence penalty as provided in [45 IAC 15-11-2](#)(c), in part, as follows:

The department shall waive the negligence penalty imposed under [IC 6-8.1-10-1](#) if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or

failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

- (1) the nature of the tax involved;
- (2) judicial precedents set by Indiana courts;
- (3) judicial precedents established in jurisdictions outside Indiana;
- (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;
- (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

The Department's audit noted that Taxpayer not only failed to collect the sales tax but also failed to establish a use tax accrual system and remit the use tax accordingly. Taxpayer did not provide sufficient documentation establishing that its failure to pay tax or timely remit tax was due to reasonable cause and not due to negligence.

FINDING

Taxpayer's protest on the imposition of the negligence penalty is respectfully denied.

SUMMARY

For the reasons discussed above, Taxpayer's protest on the imposition of sales tax on sales of its software maintenance agreements is respectfully denied. Taxpayer's protest on the imposition of the negligence penalty is also respectfully denied.

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